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No. 96-1592

Supreme Court, U.S.
FILED
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

MARILYN OLKEY, *et al*,

Petitioners,

—v.—

HYPERION 1999 TERM TRUST, INC., *et al*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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May 8, 1997

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QUESTIONS PRESENTED

1. Whether a court may dismiss a federal securities law action based on alleged prospectus misstatements where plaintiffs' allegations are contradicted by the language of the prospectus.

2. Whether, on a motion to dismiss federal securities law claims pursuant to Rule 12(b)(6), the district court was required to take judicial notice of affidavit assertions about the subjective beliefs of particular investors where the affidavits were never even submitted on the motion and the language of the prospectuses at issue fully disclosed the allegedly concealed risks.

LIST OF INTERESTED PARTIES AND RULE 29.6 STATEMENT

The petitioners are Marilyn Olkey, Lawrence Berger, Cetinna Camenzuli, Lois F. Dehaven, Gary Pshena, Janis Pshena, Herbert N. Feldstein, Charles Kornberger, Marcella Levy, Michael W. Moran, Milton V. Firestone, Alan Wolf, Leonard Newberger, Robert Perocchia, Madeleine Middlemark, Direct Reproduction Corp. Superimposed Pension Trust #3 Pension Plan Dated 5/12/92, Robert Rattner, Norman Urkowitz, Alvin Goldstein, Harvey Makofsky and David Masucci.

The respondents are Hyperion 1999 Term Trust, Inc.; Hyperion 1997 Term Trust, Inc.; Hyperion 2002 Term Trust, Inc.; Painewebber Incorporated; Hyperion Capital Management, Inc.; Alan M. Mandel; Kenneth C. Weiss; Lewis S. Ranieri; Garth Marston; Rodman L. Drake; Leo M. Walsh, Jr.; Patricia A. Sloan; David R. Odenath, Jr.; Paul V. Ippolito; Smith Barney, Harris Upham & Co., Inc.; Kidder Peabody & Co., Inc.; Merrill Lynch & Company; Oppenheimer & Co.; Prudential Securities, Inc.; Dain Bosworth, Inc.; Harry E. Petersen, Jr.; Advest, Inc.; and Crowell, Weedon & Co.

Pursuant to Rule 29.6 of this Court, respondent Hyperion Capital Management, Inc. ("HCM") states that the following are registered, public investment companies to which HCM serves as investment adviser:

The Hyperion Total Return Fund, Inc.;

Hyperion 1997 Term Trust, Inc.;

Hyperion 1999 Term Trust, Inc.;

Hyperion 2002 Term Trust, Inc.;

Hyperion 2005 Investment Grade Opportunity Term Trust, Inc.;

Hyperion Short Duration U.S. Government Fund (a series of Hyperion Government Mortgage Trust);

Hyperion Short Duration U.S. Government Fund II (a series of Hyperion Government Mortgage Trust II); and

Short Duration U.S. Government Portfolio (in which the Short Duration Funds invest their assets).

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RESPONDENTS' BRIEF IN OPPOSITION

Respondents respectfully submit that a writ of *certiorari* to review the judgment of the United States Court of Appeals for the Second Circuit entered on October 15, 1996 should not issue because petitioners present no question worthy of the exercise of this Court's *certiorari* jurisdiction and because the decision below is in all respects correct.

COUNTER STATEMENT OF THE CASE

A. Counter Statement of Facts

This case concerns federal securities law claims[1] against three closed-end investment companies (the "Trusts"). Each Trust was formed in 1992 to invest in a portfolio consisting principally of mortgage-backed securities. Each had two stated investment objectives: to provide a relatively high level of current income; and to return the initial public offering price of $10 per share to investors at the termination dates of the Trusts in 5, 7 and 10 years, respectively.

Each prospectus[2] described in detail the nature and characteristics of the different types of mortgage-backed securities and other instruments in which the Trust could invest, and set forth an anticipated portfolio, including particular per-

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1. This case does not present any issues for review under the new Private Securities Litigation Reform Act of 1995 (the "PSLRA"). The Complaint in this action was filed before the effective date of the PSLRA, and no party in this action has ever urged that the new statute should be applied retroactively to the Complaint. Both the District Court and the Second Circuit relied on the body of law that was in effect before the PSLRA.

2. A copy of each of the prospectuses for the three Trusts was included in the Joint Appendix filed by petitioners on their appeal to the Second Circuit. References to that Joint Appendix are indicated as "A. ___." The prospectuses were incorporated by reference in the Complaint. A.146.

centages for each type of instrument in which the Trust expected it would initially invest. A.287-295, 352-359, 423-430, 532. The prospectuses warned investors that the Trusts were expected to invest heavily in mortgage-backed securities, and that the Trusts' portfolios of mortgage-backed securities would be particularly sensitive to interest-rate fluctuations. The prospectuses explicitly warned that the underlying mortgages could (like any mortgage) be prepaid at any time, that a decline in interest rates could trigger a rise in mortgage refinancings and prepayments, and that such an event posed a risk to investors' capital. *See* sec. I.B below.[3]

The prospectuses stated that the Hyperion defendants would attempt to manage the portfolios so as to reduce the risks of this interest rate sensitivity. Nevertheless, each prospectus also made clear that the success of this strategy could not be guaranteed. A.280, 343, 414.

In 1993, interest rates plunged to "historic" lows. A.476-480, 514-517.[4] Homeowners rushed to refinance their mortgages at these exceptionally low rates, which caused an "unprecedented" and "record level" rise in mortgage prepayments. A.478, 479, 480. This wave of prepayments had the precise effect on the Trusts that the prospectuses had warned about. By October 8, 1993, each of the Trusts' net asset values had declined, and each of the Trusts announced that it was reducing its dividend. The first lawsuit was filed just 10 days later.

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3. The detailed prospectus disclosures (*see* sec. I.B below) regarding the volatile instruments whose interest-rate sensitivities the Trusts would attempt to manage directly contradict petitioners' claim that there was only one warning regarding risk to capital (Petition at 6) or that the prospectuses indicated that there would be "minimal risk to capital" (Petition at 2).

4. Opinion at 16a (citing "extraordinary drop" in interest rates).

B. Course of Proceedings and Disposition of the Case Below

In all, sixteen separate class-action complaints were filed against the Trusts in the weeks following the announcement that the Trusts were reducing dividends. A.7. The district court consolidated these separate actions and when petitioners eventually filed their Second Consolidated Amended Complaint (the "Complaint")[5] defendants moved to dismiss that pleading. A.11.

The Decisions Below. In an opinion and order dated July 12, 1995 (A.527-545), the Hon. Michael B. Mukasey, J., dismissed petitioners' claims. The district court found that the prospectuses "discussed candidly" the very facts petitioners claim were concealed (A.537), and that the prospectuses fully disclosed "both the Trusts' investment strategy and the attendant risks". A.529. Petitioners moved for reargument, relying on various investor affidavits that had not been part of the record on the motion to dismiss the Complaint.[6] On September 6, 1995 the district court denied petitioners' motion for reargument. A.50.

In an opinion dated October 15, 1996 (the "Opinion"), a majority of the Second Circuit affirmed (2-1) the district court's opinion, holding that the prospectuses would not have

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5. Petitioners initially filed a consolidated amended complaint which defendants promptly moved to dismiss for failure to state a claim. After that motion had been fully briefed, the court permitted petitioners to obtain limited discovery and to file a second amended complaint despite the pending motion to dismiss.

6. Petitioners now describe the affidavits as "record evidence" (Petition at i) and attack the court of appeals for supposedly not "bothering" to address them (Petition at 8). They do not advise this Court that the district court held the affidavits "were not part of the record on the motion to dismiss the second consolidated amended complaint. . . . Plaintiffs made a tactical decision to exclude the affidavits in opposing defendants' motion to dismiss the second consolidated amended complaint, and cannot now revise their strategy." Reargument Order at 49a.

misled a reasonable investor concerning the nature and risks of the investment. Opinion at 8A-19a.[7]

Petitioners filed a petition for rehearing by the panel and a suggestion for hearing by the Second Circuit *en banc*. In that brief, petitioners for the first time raised the argument that the district court and Second Circuit decisions violated petitioners' constitutional rights. On January 7, 1997, the panel denied petitioners' request for rehearing, and the Second Circuit declined to hear this case *en banc*.

SUMMARY OF ARGUMENT

This case presents no issue even remotely worthy of a grant of *certiorari*. The prospectuses at issue were incorporated by reference in plaintiffs' complaint. The Second Circuit reviewed the language of those prospectuses applying the same standard used in every circuit: it read the prospectuses to determine whether their language, in context, disclosed to a reasonable investor the risks plaintiffs claim were concealed. Contrary to petitioners' argument, the court did not rest its holding on disclosure that was "boilerplate," "vague" or "not tailored" to the risks. Petition at 14, 15. Instead, the court determined that the prospectuses "fully and explicitly" warned of "exactly the risk the plaintiffs claim was not disclosed" in language that was "extensive," "detailed," and "too prominent and specific to be disregarded." Opinion at 10a, 16a, 18a. Quite apart from the correctness of the decision below, the role of this Court is surely not to repeat the lower courts' extensive analysis of the prospectuses. The fact that petitioners disagree in this case with the outcome of the Sec-

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7. The Opinion was reported as *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2 (2d Cir. 1996). For the Court's convenience, citations to the Opinion are given as page references to the Appendix to the Petition.

ond Circuit's application of that well-accepted standard does not give rise to a conflict among the circuits.

Petitioners' argument that the dismissal violates their Seventh Amendment right to a jury was raised for the first time in petitioners' petition for rehearing and suggestion for rehearing *en banc* by the Second Circuit and should not even be considered by this Court. In any case, because the courts below properly dismissed the Complaint under well-worn principles of Fed. R. Civ. P. 12(b)(6), plaintiffs' purported constitutional claim is meritless.

REASONS FOR DENYING THE WRIT

I. The Second Circuit's Decision Is a Routine Application of Well-Settled Federal Securities Law and Creates No Conflict Among the Circuits.

A. The Second Circuit Applied the Same Standard Applied by Every Circuit

In holding that the prospectuses at issue contained no material misrepresentations, the Second Circuit applied the same federal securities law standard followed by every other circuit. The court determined as a matter of law "whether defendants' representations, taken together and in context, would have misled a reasonable investor." Opinion at 8a (internal quotations omitted). Regardless of what that analysis is called, all circuits hold that if no "reasonable investor" could conclude that the statements, "taken together and in context, were misleading, then the issue is appropriately resolved as a matter of law." *Silver v. H&R Block, Inc.*, 105 F.3d 394, 396 (8th Cir. 1997) (affirming dismissal).[8]

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8. *Accord Suna v. Bailey Corp.*, 107 F.3d 64, 70 (1st Cir. 1997) (affirming dismissal); *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1408-09 (9th Cir. 1996) (same), *cert. denied*, ___ U.S. ___, 117 S. Ct. 1105 (1997); *Melder v. Morris*, 27 F.3d 1097, 1101 (5th Cir. 1994) (same); *In*

Petitioners cannot seriously dispute that the Second Circuit applied this standard.[9] At most, petitioners quarrel with the Court's conclusion that in this instance:

> A reasonable investor could not have read the prospectus without realizing that, despite the use of balancing . . . in an attempt to minimize the impact of fluctuating interest rates, a significant downturn in interest rates could decrease the value of the Trusts and decrease earnings.

Opinion at 10a. That petitioners disagree with the outcome of the lower courts' analysis of the prospectus language in this case does not create a "split" in the circuits or an issue worthy of review by this Court.[10]

Struggling to manufacture some certworthy issue in this routine securities action, petitioners also make much of the "bespeaks caution" doctrine, which has been generally accepted by the circuits. Petition at 10-13. The doctrine, however, is no more than a specific formulation of the rule the Second Circuit followed, as petitioners' own authorities show: "[T]he bespeaks caution doctrine reflects the unremarkable proposition that statements must be analyzed in context." *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414

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re Donald J. Trump Casino Sec. Litig., 7 F.3d 357, 369 (3d Cir. 1993) (same), *cert. denied*, 510 U.S. 1178 (1994); *Raab v. General Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993) (same); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991) (same); *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991) (same).

9. Indeed, even the dissent below did not disagree with the majority's statement of the law. Opinion (dissent) at 22a.

10. Of course, petitioners avoid framing their dispute with the decision below in these terms because this Court rarely grants *certiorari* to review the alleged misapplication of a properly stated rule of law. Supreme Court Rule 10; *Rudolph v. United States*, 370 U.S. 269, 270 (1962) (dismissing writ where review "would be of no importance save to the litigants themselves").

(9th Cir. 1994) (citing *Rubinstein v. Collins* , 20 F.3d 160, 167 (5th Cir. 1994)), *cert. denied*, ___ U.S. ___, 116 S. Ct. 185 (1995); *accord Fecht v. Price Co.*, 70 F.3d 1078, 1082 (9th Cir. 1995) (the doctrine is "merely a new name for a venerable precept that does not alter the standard for deciding questions as a matter of law"), *cert. denied*, ___ U.S. ___, 116 S. Ct. 1422 (1996). Contrary to petitioners' argument (Petition at 14), this case involved no novel application of the bespeaks caution doctrine. The Second Circuit here did nothing more than conclude that the prospectuses accurately disclosed the risks that petitioners claim were concealed.

B. The Second Circuit Properly Held the Risk Disclosure in These Prospectuses Disclosed the Trusts' Risks to Reasonable Investors

Apparently realizing that the Second Circuit applied the same standard in reviewing the prospectus language that is used in all federal securities cases, petitioners try to attack the Court's analysis of the language of these particular prospectuses. Petitioners claim that the risks disclosed by the prospectuses were not sufficiently "tailored" to the risks of the Trusts' portfolios. Petition at 14. In particular, petitioners claim that the prospectuses failed to disclose the risk to investors' capital posed by interest rates. Petition at 6, 14.

This argument, as the lower courts properly concluded, cannot survive a reading of the prospectuses. The prospectuses warned investors *repeatedly* that a decline in interest rates could trigger a rise in mortgage prepayments, which posed risks to the value of the Trusts' portfolios of mortgage-backed securities. Each prospectus alerted investors that, unlike traditional debt securities, the principal of a mortgage-backed security:

> may be prepaid at any time because the underlying mortgage loans or other assets generally may be prepaid at any time. **These differences can result in significantly**

> **greater price and yield volatility than is the case with traditional debt securities.**

A.279, 341, 412 (emphasis added). Each prospectus made clear that the mortgage-backed securities in the Trust portfolios would be "subject to the risk of faster or slower than expected rates of prepayment." A.277, 338, 409. Each prospectus also made clear that prepayments had an impact on the interest-rate sensitivity of the Trust instruments: "Because of the effect that changes in interest rates may have on prepayment rates, changes in interest rates may have a greater effect on the value of Mortgage-Backed Securities than is the case with more traditional fixed income securities." A.288, 352, 423. And each warned that the likelihood of prepayments increases as interest rates decline: "In periods of declining mortgage interest rates, prepayments on Mortgage-Backed Securities generally increase." A.300, 366, 436.

The prospectuses then warned that such an increase in prepayments posed a risk to investors' capital. The interest-only strips ("IOs") intended to help create interest-rate "balance" were themselves described as "extremely sensitive" to prepayment rates. A.294, 301-302, 359, 366-367, 429, 437. The prospectuses warned that:

> If the underlying Mortgage Assets experience greater than anticipated prepayments of principal, an investor may fail to recoup fully its initial investment in an IO class of a stripped mortgage-backed security, even if the IO class is rated AAA.

Id. At the same time, the prospectuses cautioned that the remainder of the mortgage-backed securities in the portfolio "may benefit less than other fixed income securities from declining interest rates due to the risk of prepayments." A.283, 301, 347, 366, 418, 436. Thus, in its Summary section, under the heading "Interest Rate Sensitivity," each prospectus explicitly warned:

> **While the Trust will seek to minimize the impact of such volatility on the net asset value of the Trust's assets, there can be no assurance that it will achieve this result.**

A.284, 348, 418 (emphasis added). The prospectuses further cautioned that interest rate changes "will also lead to changes in the Trust's net asset value." A.275, 336, 407.

The prospectuses also made clear that the high credit quality of the mortgage-backed securities was no protection against rising prepayments. Investors were cautioned that:

> changes in both prepayment rates and interest rates will change the total return on Mortgage-Backed Securities. Under certain interest rate or prepayment scenarios, **the Trust may fail to recoup fully its investment in such securities notwithstanding the assignment of a rating of AAA to such securities.**

A.301, 366, 436 (emphasis added).[11]

Investors were thereby warned, repeatedly, that a rise in prepayments caused by a decline in interest rates could cause declines in the Trusts' net asset values. Not surprisingly, the Second Circuit held that all this risk disclosure was "too prominent and specific to be disregarded." Opinion at 10a. The court held:

> A reasonable investor could not have read the prospectuses without realizing that, despite the use of balancing . . . in an attempt to minimize the impact of fluctuating interest rates, a significant downturn in interest rates could decrease the value of the Trusts and decrease earnings.

Opinion at 10a.

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11. This detailed disclosure is hardly the single, "vague" prospectus warning petitioners claim the Second Circuit's decision turned on (Petition at 14-15).

Confronted by the lower courts' careful review of the prospectus disclosures, petitioners resort to hyperbole by arguing that the Trusts sold investors a different "product than was advertised". This allegation rests finally on petitioners' argument that the prospectuses should have made the "specific statement" that there was a "bias" in favor of rising interest rates. Petition at 14.[12] But petitioners cannot state a claim by demanding that defendants use particular magic words in their prospectuses. "Whether or not a company used the adjective plaintiff chooses should not be the focus of the Court's inquiry." *In re RAC Mortgage Inv. Corp. Sec. Litig.*, 765 F. Supp. 860, 864 (D. Md. 1991) (quoting *In re Seagate Technology II Sec. Litig.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,502, at 93,201 (N.D. Cal. May 3, 1989)). *Accord Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1277 (D.C. Cir. 1994). Since the risks of declining interest rates were "fully and explicitly" disclosed in the prospectuses (Opinion at 16a), the Complaint was properly dismissed.[13]

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12. Contrary to their assertion that defendants sold a "different product" from what was promised (Petition at 2, 6, 15), petitioners never alleged that the Trusts bought anything other than the instruments they said they could buy, in the percentages in which the Trusts said they could buy them. Opinion at 10a n.1. To the contrary, on their appeal to the Second Circuit, petitioners conceded that the detailed investment strategies set forth in the prospectuses presented a "realistic" plan to "make the capital invested relatively secure". *Id.* at 12, 21; A.133, ¶2(a). To the extent plaintiffs' current claim about a "different product" refers simply to their allegation that the risks of declining interest rates on the portfolio securities were not disclosed, the assertion is laid to rest by the detailed risk disclosure described in this section.

13. *Kas v. Financial Gen. Bankshares, Inc.*, 796 F.2d 508, 517 (D.C. Cir. 1986) ("defendants need not label or editorialize on the disclosed facts"); *Brown v. E.F. Hutton Group*, 735 F. Supp. 1196, 1201 (S.D.N.Y. 1990), *aff'd*, 991 F.2d 1020 (2d Cir. 1993).

II. Petitioners Have Not Raised any Issue Under the Seventh Amendment.

Petitioners did not raise the argument that the determination by the district court and the Second Circuit violated the Seventh Amendment until their rehearing petition in the Second Circuit. Since this argument was not timely raised in the lower courts, it should not even be considered by this Court. *E.g.*, *Wills v. Texas*, 511 U.S. 1097, 1097 (1994) ("It has been the traditional practice of this Court, however, to decline to review claims raised for the first time on rehearing in the court below."; denying *certiorari*) (O'Connor, J., concurring) (citing *Radio Station WOW v. Johnson*, 326 U.S. 120, 128 (1945)).

Petitioners are not arguing that Rule 12(b)(6) is unconstitutional. Their only argument is that the Second Circuit's affirmance of the Rule 12(b)(6) dismissal of this particular Complaint, based on a detailed review of all the language of the prospectuses, violated the Seventh Amendment. Petitioners try to create a "fact issue" to bolster their belated Seventh Amendment argument by citing to affidavits from investors in the Trusts. As discussed in footnote 6 above, however, those affidavits are not even properly before this Court because the district court held that they were not part of the record on the motion to dismiss. Reargument Order at 49a.

Quite apart from these fatal procedural defects, petitioners' "constitutional" argument fails because it is meritless. The lower courts here did not engage in impermissible fact "speculation." Instead they did just what federal courts are supposed to do on a motion to dismiss a securities claim based on alleged prospectus misrepresentations. They read the entire prospectuses and determined that the prospectuses "fully" disclosed the allegedly misrepresented risks. *See* sec. I above. The Seventh Amendment does not entitle petitioners to a jury trial on securities law claims that are contradicted by the plain language of the prospectuses.

CONCLUSION

For the foregoing reasons, the petition for a writ of *certiorari* should be denied.

Dated: May 8, 1997

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Dkt No: 95-7823

Filed: January 7, 1997

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 7th day of January one thousand nine hundred and ninety-seven.

OLKEY

Plaintiff-Appellant,

v

HYPERION 1999 TERM

Defendant-Appellee.

A petition for rehearing containing a suggestion that the action be *reheard* in banc having been filed herein by the appellant Olkey, et al.

> Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT

GEORGE LANGE III, Clerk

By: BETH J. MEADOR
Beth J. Meador,

Administrative Attorney